Letter Ruling 93-9: Security Corporation Classification; Investment in Limited Partnerships

June 21, 1993

You have requested a ruling whether the status of your client, ********** (the "Corporation"), as a security corporation under G.L. c. 63, § 38B will be adversely effected if the Corporation acquires and holds a limited partnership interest in any of three limited partnerships (the "Partnerships") which have been set up to engage in investment activities. We assume that all pertinent writings and materials as to the terms of the Partnerships have been provided to us in connection with this ruling request.

I. FACTS

The two shareholders of the Corporation (the "Shareholders") have previously acquired limited partnership interests (the "Interests") in ********** (respectively, "Partnership I", "Partnership II" and "Partnership III"). The Shareholders are not affiliated with the Partnerships, and none of the acquisitions involved negotiations.

The Shareholders now seek to transfer the Interests to the Corporation. It is assumed that no negotiations will take place in connection with these transfers, though we assume that, where necessary, the consent of the appropriate general partner will be obtained.[1]

The Partnerships are being marketed on a continuous basis to accredited investors as that term is used in Rule 501(c) of Regulation D as promulgated by the Securities Exchange Commission. The offerings are intended to be exempt from registration under the Securities Act of 1933 pursuant to Regulation D.

The specific terms of the proposed offerings, as pertinent here, are as follows:

A. Partnership I

Corporation seeks to acquire from the Shareholders their Interest in Partnership I, a Delaware limited partnership. Shareholders' Interest in Partnership I is less than 1%. Partnership I generally confers all powers of management and control upon the general partner and confers no such powers upon the limited partners.

B. Partnership II

Corporation also seeks to acquire from the Shareholders their Interest in Partnership II, which is likewise a Delaware limited partnership. Shareholders' Interest in Partnership II, like that in Partnership I, is less than 1%. Partnership II provides limited partners with voting rights, but only as to the proposed amendment of the partnership agreement. Such an amendment requires either a majority vote, or, in certain instances, a supramajority vote.

C. Partnership III

Finally, Corporation seeks to acquire from the Shareholders their 41% Interest in Partnership III. Partnership III is a California limited partnership. It is intended that Corporation's percentage interest in Partnership III will lessen as Partnership III adds additional limited partners.

Partnership III permits each limited partner to exercise a veto as to certain activities (collectively, the "Veto Rights"), irrespective as to its percentage ownership interest. The Veto Rights may be exercised with respect to, inter alia: (1) any act which would change the nature of the partnership's business; (2) the borrowing of money; and (3) particular investments that the general partner might otherwise consider (e.g. the purchase or sale of real estate and investment in debt instruments, other than bonds, government securities, certificates of deposits with recognized banking institutions or similar short-term securities).[2]

II. DISCUSSION

A. Chapter 63, § 38B

General Laws c. 63, § 38B provides preferential excise tax treatment for every domestic business corporation or foreign corporation "which is engaged exclusively in buying, selling, dealing in or holding securities on its own behalf and not as a broker." The exclusivity requirement in this provision is to be strictly construed. See State Tax Commission v. PoGM Co., 369 Mass. 611, 613 (1976); Chatham Corporation v. State Tax Commission, 362 Mass. 216, 219 (1972).

Corporations classified under G.L. c. 63, § 38B may acquire and hold securities only for the purpose of investment. See PoGM, 369 Mass at 613; Industrial Finance Corp. v. State Tax Commission, 367 Mass. 360, 366 (1975). A limited partnership interest is not a security acquired for the purpose of investment, and therefore may not be held by a security corporation, if it confers upon the limited partner the capacity for management or control. See Industrial Finance, 367 Mass. at 367; LR 82-8. We have not previously determined what constitutes management or control in the context of the acquisition of a limited partnership interest. We conclude that a right held by a limited partner does not confer management or control if that right is fundamental, as determined by analogy to corporate ownership.[3]

B. Limited Partnership Law

Limited partners may undertake certain prescribed actions pursuant to safe harbor provisions of state law without losing their limited liability. See, e.g., Del. Code Ann. tit. 6 § 17-303(b); Cal. Corp. Code § 15632. The recent trend has been for states to permit more and more powers to limited partners pursuant to these safe harbor provisions. See Smith, "Limited Partnerships - Expanded Opportunity Under Delaware Law," 15 Del. J. Corp. L. 43 (1990); "Are Limited Partnership Interests Securities?

A Different Conclusion Under the California Limited Partnership Act," 18 Pac. L.J. 125 (1985). While the safe harbor provisions provide that the actions referenced do not constitute "control" for purposes of the limited partnership law, that designation does not dictate the extent of management or control permitted under G.L. c. 63, § 38B.

The organizers of a limited partnership determine the specific powers to be conferred upon investing limited partners. These powers may be anything from no powers at all to the full ambit of powers permitted by the pertinent safe harbor provision (or more, if the organizers are comfortable exceeding

the safe harbor). See, e.g., Del. Code Ann. tit. 6 § 17-302(a); Revised Unif. Ltd. Partnership Act § 3.02, 6 U.L.A. 240 (Supp. 1986). Delaware and California are two states which permit limited partnerships to confer rights upon limited partners which exceed those generally permissible in other states. See Smith, supra at 59-60; "Are Limited Partnership Interests Securities? A Different Conclusion Under the California Limited Partnership Act," supra at 157-159. These powers permit limited partners to exercise a significant amount of control over partnership activity without losing their limited liability. Id.

C. Application of G.L. c. 63, § 38B to a Limited Partnership Interest

There are two principles which help determine the application of G.L. c. 63, § 38B to a particular limited partnership interest. First, where a limited partner possesses de facto control over some or all of a partnership's activities, that limited partner may not be a security corporation, even if its degree of control is within the parameters of the governing limited partnership act. Second, where a limited partner possesses voting rights which are substantially similar to those typically possessed by a corporate shareholder, this measure of control will generally be permissible under G.L. c. 63, § 38B. We refer to these latter types of voting rights as rights which are fundamental.

Voting rights typically possessed by a corporate shareholder pertain to matters which affect the shareholder's contract with the corporation: for example, voting rights as to (1) the election of directors, (2) the amendment of a corporate charter or by-laws, (3) dissolution, or (4) the sale, etc. of substantially all of the corporation's assets. See Kempin, "The Problem of Control in Limited Partnership Law: An Analysis and Recommendation," 22 Am. Bus. L.J. 443, 450-52 (1985). See also 13A Peairs, Business Corporations § 447 (2d ed. 1971); JRY Corp. v. LeRoux, 18 Mass. App. 153, 160 (1984). In general, a limited partner's possession of rights substantially similar to these - if exercisable in a form typically available to a corporate shareholder - will be permissible under G.L. c. 63, § 38B. On the other hand, a corporate shareholder is typically proscribed from making decisions pertaining to the day-to-day business operations of a corporation (e.g., decisions as to specific investments or company financings). See Kempin at 450-452. The ability to vote on determinations such as these is not fundamental - no matter how the right is to be exercised - and therefore such rights may not be held by a limited partner pursuant to G.L. c. 63, § 38B.[4]

In addition to the above, a veto right - or vote as to a matter which requires unanimous consent - is not typically possessed by a corporate shareholder, and therefore is not fundamental. See, e.g., H. Henn & J. Alexander, Law of Corporations § 266 (3d ed. 1983). This is so whether or not the right pertains to a shareholder's contract with a corporation. For this reason, a veto right held by a limited partner - no matter what the right pertains to - confers a degree of control that is impermissible under G.L. c. 63, § 38B. See Industrial Finance, 367 Mass. at 366. See also Marine Bank v. Weaver, 445 U.S. 551, 560 (1982) ("the provisions that the [parties] could veto future loans gave them a measure of control over the operation of the [venture] not characteristic of a security").[5]

III. CONCLUSION

A. Partnerships I and II

Corporation's acquisition of the Interests in Partnerships I and II will not, of itself, terminate its security corporation status. This is because the Interest in Partnership I will confer no rights of management and control, and the Interest in Partnership II will confer only voting rights - not exercisable by means of a veto - as to amendments made to the partnership agreement. We consider these latter voting rights to be rights which are fundamental in nature.

Corporation's holding of the Interests in Partnerships I and II will not, of itself, terminate its security corporation status if the Corporation does not exercise any management or control in connection therewith, and Corporation otherwise complies with G.L. c. 63, § 38B. In this regard, the mere exercise by the Corporation of the fundamental rights it possesses in Partnership II, without more, will not preclude security corporation status.

B. Partnership III

On the other hand, the Veto Rights conferred by Partnership III may not be held by a security corporation. These rights confer a degree of control which is impermissible under G.L. c. 63, § 38B.

Very truly yours,

/s/Mitchell Adams

Mitchell Adams
Commissioner of Revenue

MA:HMP:mtf

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[1] We note that Partnerships I and III appear to require this consent.

[2] Meetings of limited partners may be called by more than 10% of the limited partners for any matters upon which they are entitled to vote. A list of the names and addresses of the other limited partners is available to each upon request. Any action that may be taken at a meeting may also be taken without a meeting by consent, if the consent is signed by the limited partners possessing the minimum number of votes required for the action in question.

[3] Letter Ruling 89-10 ruled that a security corporation could not acquire a limited partnership interest where that interest was not a security as defined for securities law purposes. Given the widespread nature of the offerings in question and the fact that the terms of the purchases will not be negotiated, the analysis set forth in that ruling is not applicable here.

[4] Where a limited partnership right is one which has no clear analogue in the corporate area, such as rights pertaining to capital contributions, we will analogize the right to rights which are, and are not, fundamental in the corporate context to determine whether the right may be possessed by a security corporation.

[5] We note that the nature of a veto held by a limited partner is such that its threatened use as to non-managerial action could, nonetheless, affect the partnership's management.